

Political organizations; computation of taxable income. State income taxes paid by a political organization on its nonexempt function income are deductible in computing its taxable income.

#### ISSUE

Are state income taxes paid by a political organization on its nonexempt function income deductible in computing political organization taxable income for federal income tax purposes under section 527 of the Internal Revenue Code?

#### FACTS

P, a political organization that is exempt from federal income tax under section 527 of the Code and that is located in state ST, received nonexempt function income during the taxable year. State ST imposed an income tax on P's nonexempt function income for the taxable year, less deductions that were directly connected with the production of the nonexempt function income and with certain modifications not relevant here. For federal income tax purposes under section 527(c) of the Code, P proposes to deduct the state income taxes in determining its political organization taxable income for the taxable year in which such taxes are paid.

#### LAW AND ANALYSIS

Section 164(a)(3) of the Code allows a deduction for state, local, and foreign income taxes that are paid or accrued within the taxable year. Section 164 is contained in chapter one of the Code.

Section 527(a) of the Code provides that political organizations are subject to federal income taxation to the extent provided in section 527. Section 527(b) imposes a tax for each taxable year on the political organization taxable income of every political organization.

Section 527(c)(1) of the Code defines political organization taxable income as an amount equal to the excess (if any) of the gross income for the taxable year (excluding any exempt function income as defined in section 527(c)(3)), over the deductions, allowed by chapter one, that are directly connected with the production of the gross income (excluding exempt function income), computed with certain modifications not relevant here.

Section 1.527-4(c) of the Income Tax Regulations provides that to qualify as deductions in computing political organization taxable income, expenses, depreciation, and similar items must not only qualify as deductions allowed by chapter one of the Code, but must also be directly connected with the production of political

organization taxable income, expenses, depreciation, and similar items must not only qualify as deductions allowed by chapter one of the Code, but must also be directly connected with the production of political organization taxable income. To be directly connected with the production of political organization taxable income, an item of deduction must have a proximate and primary relationship to the production of such income and must have been incurred in the production of such income. Deductible items attributable solely to items of political organization taxable income are approximately and primarily related to such income. Whether a deductible item is incurred in the production of political organization taxable income is determined on the basis of all of the facts and circumstances of each case.

State income taxes paid or accrued on nonexempt function income are attributable solely to items of political organization taxable income and, therefore, have a proximate and primary relationship to the production of nonexempt function income. In addition, the liability for state income taxes on nonexempt function income is incurred solely because of the production of such income. Therefore, state income taxes on nonexempt function income are directly connected with the production of such nonexempt function income.

A deduction for state income taxes paid is allowable in determining a political organization's taxable income only if the requirements of both sections 164 and 527 of the Code are met. Although, a deduction generally is allowable under section 164 for state income taxes paid, section 527(c)(1) precludes a political organization from taking a deduction for state income taxes paid that are attributable to exempt function income. Thus, only those state income taxes that are attributable to nonexempt function income may be deducted under section 527.

#### HOLDING

For federal income tax purposes under section 527(c) of the Code, state income taxes paid by P on its nonexempt function income are deductible in computing P's taxable income for the taxable year in which such taxes are paid.